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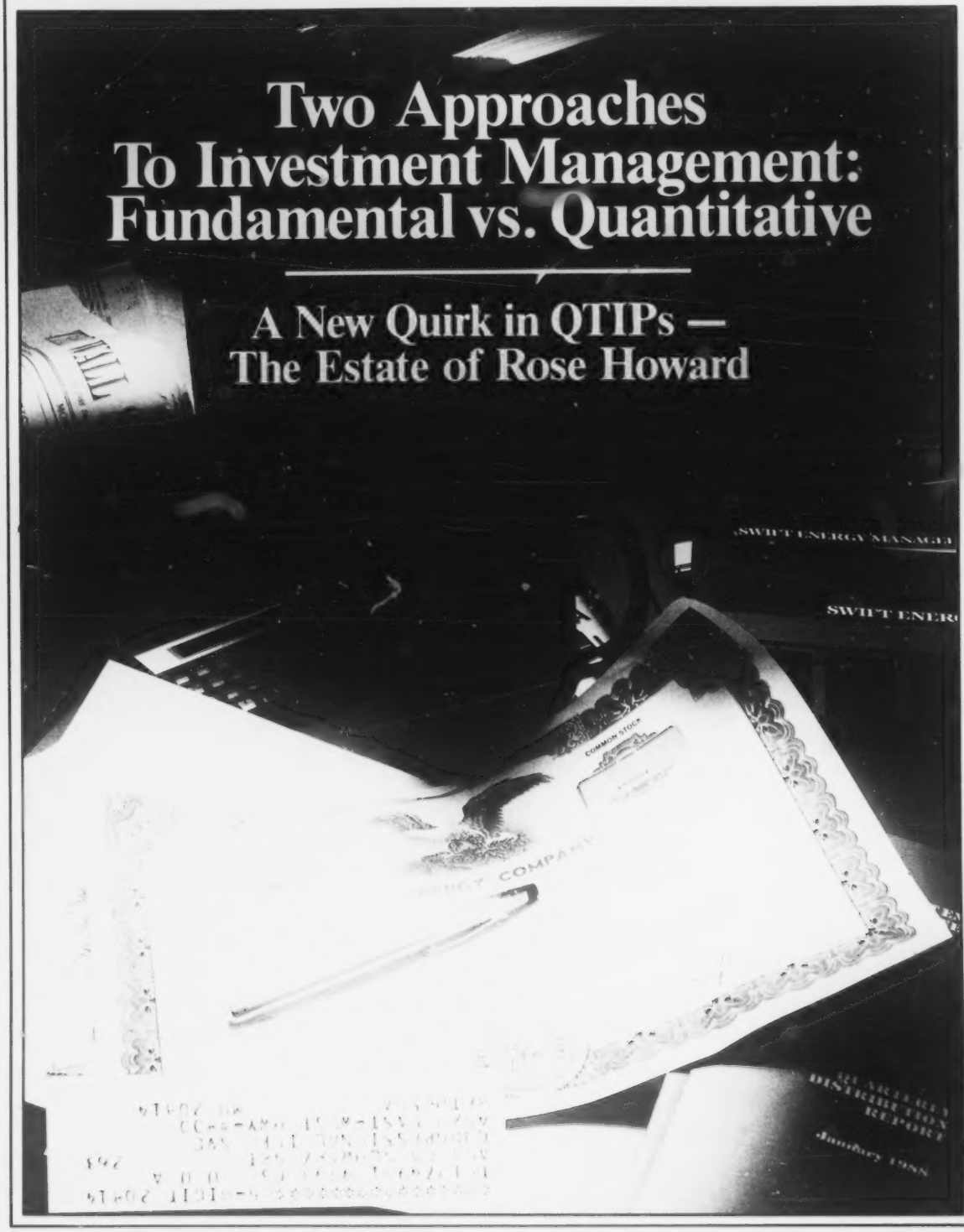
TRUSTS & ESTATES
ESTATE PLANNING & ADMINISTRATION
A Publication of Communication Channels, Inc. NOVEMBER 1988

Two Approaches To Investment Management: Fundamental vs. Quantitative

A New Quirk in QTIPs — The Estate of Rose Howard



TRUSTS & ESTATES®

Volume 127, No. 11 — Estate Planning and Administration Since 1904 — NOVEMBER 1988

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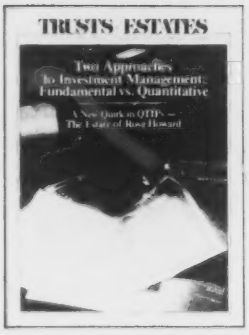
TRUSTS ESTATES
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A New Quirk in QTIPS — The Estate of Rose Howard

COVER

Ever since the Tax Reform created new investment opportunities and dissolved old ones, banks have adopted various investment management techniques. Cover photograph courtesy of Swift Energy and Bob Werre Photography, Houston, Texas.

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BPA

Commentary

Choosing A Suitable Management Style

Fundamental versus quantitative — a basic investment management decision made by all trust institutions. The decision on which style is best in each case depends on many variables. Both can and have been successful. This month we spotlight two of the most respected trust institutions in this country who line up on opposite sides of the management spectrum.

Provident National Bank in Philadelphia has chosen the fundamental approach. Malcolm C. Wilson, senior vice president, director of Investment Research and chief investment officer describes Provident's highly successful strategy which relies heavily on research and analysis by securities analysts and economists to implement the low-relative-valuation approach to equity investing.

James D. Miller, vice president and manager of the Personal Investments Division for the Trust and Investment Department at Mellon Bank describes his bank's equally successful quantitive approach, which depends heavily on research and analysis to determine and measure risks associated with equity investing via sophisticated computer systems.

Within the realm of the investment universe, mutual funds have been given a great deal of attention lately. R. Todd Ruppert, vice president and manager of the Financial Institutions Division for T. Rowe Price in Baltimore, describes in his article this month how investment officers can use some of the more than 2,000 stock, bond and income funds currently available to diversify an investment plan over different types of assets and different sectors within asset classes. He also shows us how mutual funds can help reduce portfolio volatility while still providing the opportunity to earn competitive returns.

Real estate investment partnerships have also been given a great deal of play in the investment media, but what about other types of partnerships? In his article, Mark S. Thompson, executive vice president of Equity Resources Group in Cambridge, Massachusetts, focuses on helping the fiduciary to understand the principles of valuation and investment management applicable to non-real estate investment partnerships such as oil and gas, cable television and leased equipment.

Finally this month, because of the flood of telephone calls received at the offices of Milbank, Tweed, Hadley & McCloy concerning the recent United States Tax Court decision on *Estate of Rose Howard vs. Commissioner*, Jonathan Blattmachr of the firm and Douglas J. Blattmachr, vice president of Idaho First National Bank in Boise, have written an article for this month's issue which attempts to clear up some of the confusion. The decision holds that an interest cannot constitute a qualified terminable interest property ("QTIP") if that income is paid to the next eventual estate rather than being paid to the beneficiary-spouse's estate or at least be subject to that spouse's general power of appointment. This finding is directly contrary to proposed Treasury Department regulations. □

Mutual Funds Reduce Volatility And Improve Returns

Through selective use of mutual funds, trust officers can provide clients with an investment plan that might otherwise not be feasible

By **R. TODD RUPPERT**
Vice President
T.Rowe Price Associates
Baltimore, Md.

Meet John Jones, the model bank trust investment officer. He is knowledgeable about all securities whether they be stocks, bonds, money market instruments, or real estate and other tangible assets. He is as skilled in selecting high-yield bonds as government bonds, small company stocks as blue chip stocks, commercial real estate as residential real estate. Moreover, he thoroughly understands not only the U.S. financial markets, but many overseas as well.

In addition to his extensive investment responsibilities, Mr. Jones has time to develop new business, to cultivate relationships with existing clients, and to concentrate on improving the performance and reducing the risk for accounts under his wing.

Our Mr. Jones is, of course, a myth. Even with the aid of in-house research staffs, few investment managers have the time or resources to keep abreast of all investment opportunities in all securities markets worldwide. Many trust officers, however, have achieved this capability in an efficient, cost-effective, and time-saving manner by utilizing no-load mutual funds in managing trust assets.

The broad range of mutual funds available provide trust officers the opportunity to complement their own investment expertise in developing a well-diversified investment program designed to meet a client's risk and return preferences. Very few bank trust departments can replicate the in-depth coverage of the entire spectrum of investments that can be found in the mutual fund industry today.

There are currently more than 2,000 stock, bond, and income funds, employing a variety of investment approaches and providing convenient access to a myriad of securities markets. In 1975, mutual funds fit neatly into seven main categories. Today, 22 are required. Included in the equity sector, for instance, are funds investing in stocks of small, emerging growth companies, well-established growth companies, natural resource concerns, high dividend-paying stocks, foreign stocks or individual foreign markets, and specific industries such as health care, real estate, technology, energy, gold, and consumer services. Fixed-income funds include those concentrating on high-quality government and corporate issues, lower-quality, higher-yielding bonds, foreign bonds, intermediate-term bonds with shorter maturities, and tax-exempt municipal issues.

In addition to variety and professional management, one of the key advantages inherent in mutual funds is broad diversification.

In addition to variety and professional management, one of the key advantages inherent in mutual funds is broad diversification. Within a specific investment area, a fund's assets are spread over numerous securities targeted to achieve the fund's objective. If a trust officer wanted to allocate 10 percent of a client's portfolio to aggressive growth stocks, for example, a fund investing in this sector will provide more diversification than investing in a handful of individual stocks directly. Since these types of stocks tend to be more volatile than the general equity market, a strategy that enhances diversification within the sector should help reduce the portfolio's overall risk exposure.

Through selective use of mutual funds, trust officers can efficiently and economically provide clients with a more diversified investment plan than might otherwise be feasible given the size of the account. Tapping this reservoir of investment expertise also enables trust managers to devote more time to asset allocation, which several studies have ranked higher in importance in the portfolio management process than selecting individual securities. With this approach, the fiduciary is le-

veraging his or her efforts on behalf of the client by focusing more on portfolio structure and performance while "hiring" full-time professional managers for specific investment sectors.

Benefits of Diversification

One of the best ways to reduce portfolio volatility and the client's risk exposure is to develop an investment plan that is diversified among different types of assets. Where appropriate, mutual funds can provide further diversification within each asset class.

A portfolio that includes a variety of different investments should prove less volatile than one concentrated in a single type of investment, such as stocks or bonds. At the same time, it can provide a higher return than a portfolio restricted to the most conservative types of assets, such as money market securities. Diversification offers this dual benefit because each investment sector follows a cycle all its own. Each responds differently to changes in the economy or financial markets. If you own a variety of assets, a short-term decline in one can be balanced by others which are stable or going up. In short, a diversified investment plan is better prepared to weather varying economic cycles and market conditions.

While the U.S. stock market was declining sharply in the fourth quarter of 1987, for example, foreign bonds were achieving impressive returns and turned in an outstanding record for the year. Conversely, when the dollar's rally undermined returns on foreign bonds in the first half of this year, the U.S. stock market was posting a strong showing. The long-term benefits of diversification are illustrated in Charts I and II.

CHART I

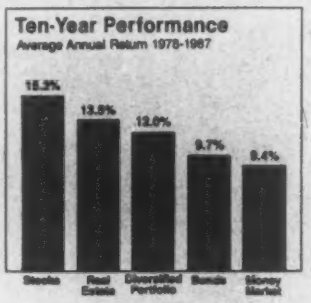
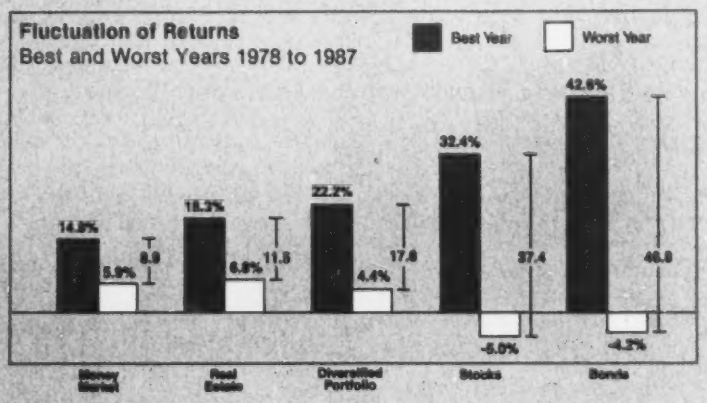


Chart I shows the performance over the past decade of four major asset categories — stocks, bonds, money market instruments (90-Day Treasury bills), and income-producing real estate — compared with a diversified portfolio split evenly among these various assets (Chart II). Several portfolios shown performed well on average over the 10-year period. A five-year bull market made the all-stock portfolio the top performer, followed by the all-real estate portfolio. The diversified portfolio provided a competitive return which exceeded that of bonds and money market instruments. But performance is only part of the picture.

Chart II shows the difference between each portfolio's best and worst years during the decade. The money market, real estate, and diversified portfolios all produced a positive return every year. Stocks, the overall performance leader, had the single worst year of the assets measured, dropping 5 percent in 1981. With a 42 percent one-year return, bonds posted the single best year of any investment, but in their worst year they declined 4 percent. Importantly, the range between the best and worst returns for any one year was much less for the diversified portfolio than for stocks or bonds. In practical terms, the higher volatility of stocks and bonds means higher risk.

The money market and real estate portfolios provided greater stability than the diversified portfolio, but have other drawbacks. Real estate is far less liquid than stocks and bonds and is most suitable for long-term investments. While money market securites provide liquidity and low risk, the overall return from the money market portfolio was 22 percent lower over the 10-year period than the return from the diversified portfolio, a high price to pay for incremental stability. The diversified portfolio, on the other hand, produced an attractive return and provided both liquidity and comparative stability.

CHART II



Sources: Stocks: Standard & Poor's 500 Stock Index. Real Estate: Evaluation Associates. Average performance for institutional real estate funds (before fees) representing $23 billion in assets. Bonds: Salomon Brothers Long-Term Bond Index. Money Market: 90-Day Treasury Bills. Diversified Portfolio: Split evenly among stock, bond, real estate and money market securities.

Diversifying With Funds

Gerald W. Perritt, president of the Chicago-based Investment Information Services, reached similar conclusions from his own study. In a recent issue of the AMERICAN ASSOCIATION OF INDIVIDUAL INVESTORS JOURNAL, Mr. Perritt examined the performance of a diversified portfolio vs. stocks and Treasury bills from 1968 to 1987. His "all-weather" portfolio, which used various types of mutual funds, was allocated as small capitalization stock funds: 10 percent to 20 percent, large capitalization stock funds: 10 percent to 20 percent, international stock funds: 10 percent to 20 percent, international bond funds: 5 percent to 15 percent, domestic bond funds: 10 percent to 30 percent, gold funds: 5 percent to 15 percent, money market funds: 5 percent to 25 percent.

During this 20-year period, Treasury bills provided a 7.4 percent compound average annual return, or 1 percent above the average annual rate of inflation. Stocks, as represented by Standard & Poor's 500 Stock Index ("S&P Index"), averaged a 9.2 percent annual return, or 2.8 percent per year more than inflation. The all-weather portfo-

lio provided the best return — an average of 11.8 percent annually, or 5.4 percent more than the annual rate of inflation. Further, the all-weather portfolio involved only minimal risk exposure. It lost ground during just two years, 1969 and 1974, compared with five negative years for the stock market. And, while the equity market declined by as much as 26.5 percent during one year (1974), the worst single-year decline in the diversified portfolio was 2.6 percent (1969).

During the stock market's collapse last October, when stock prices dropped by nearly 30 percent, Mr. Perritt's theoretical all-weather portfolio declined by slightly more than 7 percent. Moreover, that loss was largely erased two months later; the portfolio gained 6.4 percent for all of 1987. "Risk-conscious, growth-oriented investors should seriously consider adopting an asset allocation approach to managing their financial assets," Mr. Perritt concluded.

Sector Diversification

Once an appropriate asset allocation plan has been designed, the trust officer can utilize various types of mutual funds to broaden the portfolio's range within each asset class. By using a combination of funds, the trust officer is not only gaining more diversification in terms of investments, but also in terms of investment managers. With this approach, the portfolio's exposure to any one fund or manager is reduced. Selecting the specific types of funds to fill out the portfolio, of course, depends on each client's financial objectives, time horizons, and risk tolerance. For illustration, however, let's assume that the trust manager decides that half of the client's assets should be invested in common stocks.

In addition to the core holdings of individual securities, the trust officer might invest a portion of the assets in foreign stock markets to gain international diversification. This strategy offers several advantages. To begin with, foreign markets represent more than two-thirds of the world's equity capitalization and are increasing in share as foreign economies experience more rapid secular growth. Therefore, by investing solely in the U.S. equity market, the investor not only excludes the major portion of the investment possibilities worldwide, but, more importantly, the faster growing portion. In fact, equity participation in many emerging and fast growth industries can only be attained through foreign investment.

Foreign markets also offer the opportunity to improve performance. Returns from equity investments outside the U.S., as measured by Capital International's Europe, Australia, and the Far East Index ("EAFE") have surpassed those achieved by the S&P Index for each of the past nine 10-year periods (Chart III). In addition, the U.S. equity market has underperformed most foreign equity markets over the past five and one-year periods in both U.S. dollar and local currency terms. Finally, adding a foreign component can help reduce risk, and overall portfolio volatility, since foreign securities markets exhibit low correlation with the U.S. market.

Risk reduction is also achieved because no one market consistently produces superior or inferior returns. The investor thus reduces the likelihood of having a large portion of his or her portfolio in the worst performing markets, while increasing the odds of capturing the best performing markets.

The bottom line is that international diversification can, over the long-term, enhance overall portfolio returns and reduce volatility. An international mutual fund investing in foreign stock markets is a convenient way to take advantage of this opportunity. The mutual fund approach provides professional management and research in a complex area, broad diversification among different markets and securities with a single investment, a daily price quoted in U.S. dollars, low cost, and daily liquidity.

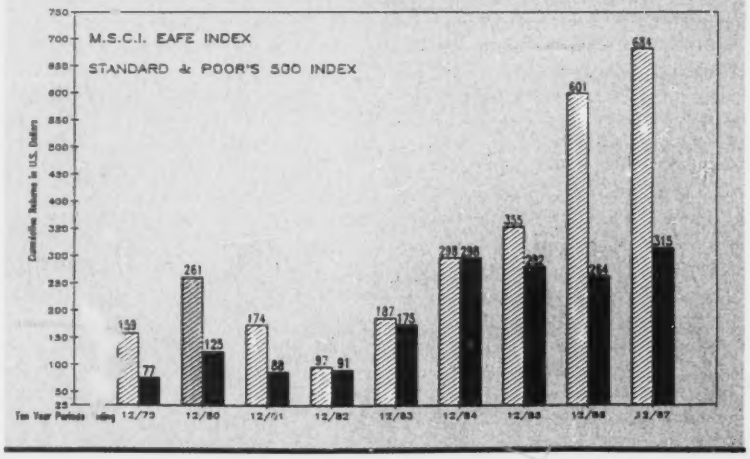
As indicated earlier, another equity area where mutual funds are an attractive alternative to individual stocks is small, growth companies with market capitalizations generally under $500 million. These so-called emerging growth stocks, or secondary stocks, generally have much faster growth rates than larger companies and, as a result, have outperformed the broad stock market over longer periods, according to Ibbotson Associates. While small company stocks offer a higher potential return, they also tend to be more volatile, due in part to their relatively smaller capitalizations. And because these companies are less seasoned, in-depth research is a "must" to reduce individual stock risk.

For more aggressive, long-term oriented clients, investing a portion of the equity assets in emerging growth stocks may be appropriate for their higher growth potential. Funds investing in such stocks provide a good way to participate since they offer broad diversification and intensive research in the sector. Moreover, many market analysts feel these secondary stocks represent excellent value because valuations are currently at historically low levels relative to the general market. Emerging growth stocks have traditionally outperformed during bull markets and underperformed during down cycles.

From mid-1983 until late 1987, however, small company stocks significantly lagged those of larger companies, and, in fact, declined more severely than the broader market in the

CHART III

U.S. International Equity Market Performance Comparison M.S.C.I. EAFE Index vs. Standard & Poor's 500 Index



aftermath of Black Monday. Although small company stocks led the market rally in the first half of this year, relative valuations at midyear remained historically low.

A Conservative Approach

For more conservative clients, of course, the emerging growth sector may not be appropriate. In such cases, trust officers may want to consider equity income funds, which represent an income-oriented strategy emphasizing high-yielding stocks with some growth potential.

Equity income funds are the most conservative stock funds in the mutual fund industry because prices of stocks which provide a high level of current income tend to fluctuate less than those with below-average dividends. Dividends are normally a more stable and predictable component of return than capital appreciation, helping to cushion the decline in a stock's price during market downturns. Equity income funds are often overlooked. For one thing, they lack "sex appeal," since high dividend-paying stocks tend to be associated with mature, glamourless companies, such as electric and telephone utilities, or those that are slower growing and possibly out of favor. Also, many investors underestimate the potential of the income component of total return. For example, reinvested dividends accounted for almost half the total return from the S&P Index for the 10-year period ended 1987.

Over this decade, a $1,000 investment in the stock market, on average, would have grown to $4,144. Of the $3,144 gain over the original investment, $1,544, or 49 percent, represents reinvested dividends and $1,600 is price appreciation. Although equity income funds are generally less volatile than the overall market, they have generated competitive returns. For the 10-year period ended June 30, 988, equity income funds, on average, provided a total return of 344 percent, according to Lipper Analytical Services, Inc. This compares with a 353 percent total return for the S&P Index.

The steady and less volatile returns that high dividend-paying stocks can provide is also documented in a recent study by Prescott, Ball & Turben, a Cleveland securities firm. The study compared the performance of the 10 highest-yielding stocks in the Dow Jones Industrial Average with the INDEX'S overall performance over the last 16 years. From 1972 through 1987, the high-yield stocks turned in an average annual return of 18.4 percent compared with 10.8 percent for the Dow Jones Industrial Average. And, significantly, the high-yield group exhibited less volatility, particularly in down years. In 1973, the worst year in the period covered, the return on the Dow Jones Industrial Average plunged to -23.4 percent, while the high-yield stocks declined only 2.9 percent.

Fixed-Income Alternatives

Just as the trust officer may find equity funds an efficient way to diversify the common stock portion of a client's portfolio, he or she may use certain types of bond funds to complement the fixed-income investments. As with the equity funds, bond funds may be most practical for markets that require more extensive research than in-house resources can accommodate and where broad diversification is crucial.

In recent years, for example, institutional investors have shown increased interest in foreign bond markets, for much the same reasons they were attracted to foreign stock markets: the opportunity to achieve higher total returns while reducing overall portfolio volatility. Foreign bond markets collectively account for more than half the $9.4 trillion outstanding supply of bonds. As in the U.S., slightly over half of total foreign bonds outstanding are obligations of governments or government agencies.

Investment in foreign fixed-income securities generally provides greater diversification than a portfolio limited to only U.S. debt issues, since prices and yields of foreign securities are not determined by the U.S. securities market. Interest rate movements in most international bond markets seldom correlate with the U.S. bond market. This means, for example, that a foreign bond component in a portfolio can help maintain yields when U.S. interest rates are falling because there will always be some countries with higher rates than those in the U.S.

Conversely, if U.S. interest rates are rising, foreign bonds can buffer a portfolio against price declines, because rates will not necessarily be rising worldwide. Thus, the portfolio's overall volatility is reduced. In addition to providing diversity, data also show that average returns on foreign bonds have consistently outperformed average returns on U.S. bonds since 1972, based on research by Ibbotson Associates and Salomon Brothers. Over rolling 10-year holding periods starting in 1972, a portfolio of foreign bonds provided an average annual return of 12.6 percent in U.S. dollars compared with 8.8 percent for a portfolio of dollar-denominated bonds.

Foreign bonds can be more volatile than U.S. bonds over shorter-term holding periods, due in part to currency fluctuations, but have shown less volatility over longer-term periods. The total return on foreign issues can be enhanced or reduced by fluctuations in foreign exchange rates. Over longer time periods, however, experience has shown that the net effect of currency fluctuations on returns is negligible.

Because of the complexities of investing in foreign bond markets and the difficulty, in some cases, of obtaining comprehensive information, international bond funds have been the route most U.S. investors have chosen to internationally diversify their fixed-income portfolios. This is reflected in the rapid growth of such funds; total assets quadrupled to $2.8 billion between the end of 1986 and June 1988.

High-Yield Bond Funds

High-yield bond funds represent another alternative available to trust officers looking to generate a higher level of income, and possibly higher total returns, on the client's fixed-income investments. These funds invest in longer term, lower-quality bonds which are generally issued by four types of companies:

- FORTUNE 500 or 1000 companies that have lost their investment-grade status because of difficulties of some kind. These "fallen angels" comprise 30 percent of outstanding high-yield bonds.
- Young, rapidly growing companies which characteristically have high profit margins and a lot of debt. These "rising stars" are the most frequent issuers of high-yield debt.
- Companies or individuals undertaking leveraged buyouts. These usually friendly transactions frequently include company management and are financed with high-yield issues.
- Firms involved in industry-wide deregulation or extensive restructuring, such as trucking and airlines, utilities with nuclear exposure, energy companies, and so on. This category may include some fallen angels.

Because noninvestment-grade bonds represent greater credit risk, their yields have historically exceeded those on investment-grade issues by about three percentage points (300 basis points), and

sometimes by more than 500 basis points. On a total return basis (principal change plus income), high-yield bond funds have significantly outperformed high-grade bond funds. For the 10-year period ended June 30, 1988, high-yield funds, on average, achieved a total return of 197 percent compared with 163 percent for high-grade funds, according to Lipper Analytical Services, Inc.

The superior performance of the high-yield sector is reflected in Chart IV, which compares the annual returns over the past five years and the first half of this year for the First Boston High Yield Index and the Shearson Lehman Government/Corporate Bond Index. "Over the last seven years," observes First Boston Corp. "The high-yield (bond) market offered a compound annual return of 16.4 percent, which is 100 to 300 basis points higher than returns on other securities. "While measures of return are the ultimate test for investors, volatility risk is the most important offset to return. For the last seven years, the First Boston High Yield Index posted a volatility of annual returns of 9.79 percent, the lowest for any security type, except the Shearson Lehman Government Agency Index, which has a shorter duration. The long-term record for high yield investment is strong; high returns (including defaults) with low volatility."

First Boston adds that the second most important risk for investors in corporate securities is credit risk. In this regard, the firm states: "The high-yield market in 1987 experienced the largest default in history, $5.4 billion of Texaco securities. Yet, in the face of this massive default, 1987 returns were reduced by only 1.88 percent as a result of defaults and exchange offers, which compares with an average for the 1977-1987 period of 1.75 percent. Texaco was an unusual default, since it was the result of unusual legal interpretations."

Noninvestment-grade bonds do pose higher credit risk than high-quality bonds, however. Between 1974 and 1975, for instance, the average annual default rate on low-grade bonds was 1.5 percent, compared to 0.09 percent for all public corporate bonds. Due in large part to problems in the energy and steel sectors of the economy, the 1986 default rate on high-yield bonds rose to about 2.5 percent. Of course, bonds in default retain some value and may ultimately repay principal. Nevertheless, investing in this area requires extensive credit research and a broadly diversified portfolio to minimize the impact of occasional defaults. For these reasons, high-yield bond funds, particularly those that do their own credit analysis rather than relying on credit rating agencies, provide a suitable vehicle for participation in the high-yield market.

A Role for Real Estate

Up to now, our discussion has focused primarily on the selective use of various types of specialty mutual funds to enhance diversification among financial assets. For clients with long time horizons, trust officers should also consider the benefits of income-producing real estate.

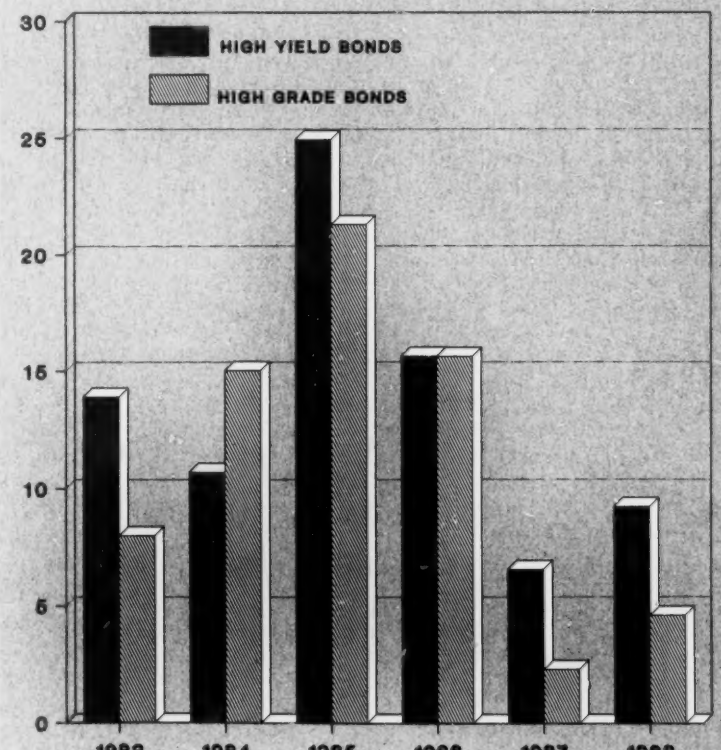
A diversified portfolio of income-producing real estate has historically been a much more stable investment than either stocks or bonds and is the only one of the three assets that has achieved a consistently positive return for nearly two decades. Adding real estate to a portfolio of financial assets can, therefore, reduce its overall volatility. Although real estate is less liquid than stocks or bonds, it adds ballast to a portfolio because real estate is not necessarily subject to the same influences as financial assets. Stocks and bonds, for instance, are more sensitive to short-term swings in economic developments and investor psychology than real estate.

Well-located, income-producing properties can also provide an attractive level of current income which is partially sheltered from taxes by depreciation, as well as the potential for capital appreciation over time. Over longer time periods, real estate returns have been competitive with those on common stocks, exceeded returns on bonds, and have just about always beaten inflation. As seen in Chart I, investment-grade, income-producing properties provided an average annualized return

CHART IV

Performance Comparison

Annual Total Return High Yield Bonds vs. High Grade Bonds



Source: First Boston Corp.

of 13.5 percent for the 10-year period ended 1987, compared to 15.3 percent for the S&P Index, 9.7 percent for Salomon Brothers' Long-Term Bond Index, and 9.4 percent for 90-day Treasury bills.

There are, of course, several ways to participate in real estate. Real estate limited partnerships, like mutual funds, offer professional management and diversification. Partnerships represent long-term investment programs, however, with limited liquidity. Typically, properties in the fund are sold over a seven to 10-year period. Real estate investment trusts offer another alternative. Like limited partnerships, equity REIT's provide investors with a professionally managed, diversified portfolio of real estate properties. In addition, REIT's provide liquidity since their shares are typically traded on major stock exchanges or over the counter.

Since REIT shares are listed on stock exchanges, however, their value is influenced by the general fluctuations in the financial markets. As a result, REIT's tend to be more volatile than limited partnerships and do not offer the same degree of investment diversification. But whichever approach is chosen, the long-term benefits of real estate should not be overlooked.

Features of Mutual Funds

In addition to variety, professional management, and diversification, mutual funds offer several other fundamental features that dovetail with the requirements of trust management.

Liquidity. By law, all open-ended mutual funds must stand ready on any business day to redeem any or all shareholders' investments on the day the order is received. Investors in mutual funds do not encounter the liquidity problems that can occur in some individual securities, particularly those that are thinly traded or heavily owned by institutions. Moreover, redeeming a large position in a mutual fund does not affect the net asset value per share as it might the price of an individual stock. And, with no-load funds, there are usually no charges for redeeming or purchasing shares. Redemption and purchase orders can generally be placed by phone or letter, and checks can be written on most money market funds and many bond funds. Some fund groups even offer do-it- yourself, 24-hour purchase and redemption service by phone.

Exchange Privileges. Many mutual fund groups provide exchange services which allow investors to switch all or part of their investment from one fund to another by phone. This service enables trust officers to quickly and conveniently reposition a portfolio between stock, bond, and money market investments as market conditions or the client's needs change. There is usually little or no cost for exchange transactions, and investors avoid commission costs for selling and buying individual securities.

Stated investment objectives. Mutual funds provide a clear statement of their investment objectives in the prospectus and often describe their investment philosophy and approach as well. This helps the trust officer focus on funds that are suitable for a client and which will complement or fill a particular niche in the portfolio.

Performance record. A fund's performance record is easily assessed since this information is supplied by the prospectus or accompanying literature and is available in more detail from the fund. The fiduciary can determine how successfully the fund has achieved its objective, how its performance compares with a suitable market index or similar funds, and whether the overall returns were produced consistently or erratically.

Record-Keeping. Considerably less record-keeping is involved in owning a handful of mutual funds than in owning a diverse portfolio of individual securities. Funds provide regular statements summarizing performance and all dividend and capital gain distributions, noting whether they were reinvested or taken in cash. The fund also provides information on the federal tax status of the investor's earnings in the fund.

Cost effective Mutual funds generally have expense ratios (ratio of expenses to average net assets) ranging from 1 percent to 2 percent covering administrative and management services. For many bank trust departments, it is considerably more cost effective to participate in certain markets through funds than to acquire the necessary resources and expertise in-house. As a result, the bank can serve the customer better and maintain a competitive fee schedule. And, if a client's needs change, it is less costly to reposition the portfolio through the purchase and sale of no-load funds than it would be with individual securities.

A recent SEC rule has also made it much easier to understand and compare the relative costs of investing in mutual funds. All fund prospectuses now contain a table that clearly shows shareholder transaction costs and annual fund operating expenses, including sales loads, redemption fees, exchange fees, 12b-1 (distribution) charges, and management fees. In addition, the table must show the total costs incurred by the investor after one, three, five and 10 years, assuming a $1,000 initial investment and a 5 percent annual rate of return.

Institutional Involvement

These and other advantages funds offer have made them increasingly popular among institutional as well as individual investors. In addition to banks and other fiduciaries, institutional investors using funds include business corporations, employee pension and profit-sharing plans, insurance companies, and foundations. Total institutional assets in mutual funds rose from about $6 billion in 1970 to $272 billion in 1987. The wide variety of mutual funds available, and the services they offer, provide fiduciaries with the opportunity to broaden a client's overall investment diversification economically and conveniently. This broader diversification should help reduce overall portfolio volatility while achieving competitive returns.

The selective use of mutual funds in managing trust assets should enhance, not jeopardize, the relationship between the client and the trust officer. By integrating mutual funds where appropriate into the investment program, the trust officer is able to achieve several goals: (1) improve client service, (2) devote more time to relationship-building, (3) focus more on asset allocation and proper structuring of the overall portfolio to meet the client's needs and expectations.

There is no erosion of fiduciary responsibility when certain funds are used if they are suitable for the client and their investment benefits improve overall performance, reduce risk, or both. For most trust officers, mutual funds will play only a supporting role. But if the casting is done with care and precision, the chances are much better that the final production will be a hit. □

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